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FIDESZ ECONOMIC PLAN

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Classified By: Acting P/E Counselor Jon Martinson, reasons 1.4 (b,d)

¶1. (U) Summary. Despite a steep recession, high unemployment and weak domestic consumption, Hungary is beginning to see some "green shoots" of recovery, in the form of improving investor confidence and greater financial stability. Some credit the government's economic reform and fiscal consolidation efforts, while others believe an improved global investor climate is the primary cause. The opposition believes the government reforms will do little to improve Hungary's economic competitiveness, and complain that the Bajnai government's plan does not tackle structural issues like combating corruption, simplifying government, or reducing the size of the informal economy.

¶2. (C) With national elections scheduled for next April, commentators are increasingly looking to the opposition FIDESZ party - the expected winner - for details of their economic plan. Few details exist, however, as FIDESZ remain wary of alienating potential voters prior to the election. Supporters must rely largely on faith and FIDESZ's fiscal track record to reassure them that the Party will pursue economic policies that will help improve Hungary's economic competitiveness. Although this strategy could help ensure a FIDESZ victory, it does little to prepare the public for further austerity measures and may delay the implementation of their economic plan. End summary.

HUNGARY'S GREEN SHOOTS

¶3. (SBU) Although Hungary remains in a deep recession, with GDP expected to decline this year by 6.7 percent, unemployment holding steady at 10 percent, and domestic consumption remaining weak, there have been a growing number of positive signs in recent weeks of higher investor confidence and improved financial stability. Hungary's exchange rate continues to strengthen, currently trading at around 270 to the Euro, down from a low in March of around ¶317. This helps ease pressure on the large number of households and businesses borrowing in foreign currencies (which in turn should help slow the increase in banks' non-performing loan rates), and reduces the foreign funding costs of both the government and banks. There is also increased demand for Hungarian government securities in recent weeks. Importantly, Hungary returned to the international capital markets last month with a successful Euro 1 billion eurobond issuance. Another sign of improving investor confidence is that Hungarian credit default swap (CDS) spreads have lowered to "pre-Lehman" levels and the Hungarian National Bank (MNB) has been able to resume reductions in Hungary's high interest rate (currently 8.5 percent). Finally, Hungary's trade balance and current account situation continues to improve, although this is

primarily caused by imports declining more rapidly than exports (due to continued weak domestic demand).

¶4. (C) Economists remain cautious, however, and note that risks remain to financial stability. Central Bank Vice President Julia Kiraly told U.S. Treasury Representative for Europe Mathew Haarsager that despite the easing of market conditions, she believes the recession poses the greatest risk to financial stability. A deep and prolonged recession would have a negative effect on employment rates, which in turn could increase banks' non-performing loan rates, adversely impacting the financial sector. This is why, she notes, the Central Bank continues to conduct stress tests on financial institutions in Hungary, to ensure banks are adequately capitalized to withstand potential market stresses.

¶5. (C) While acknowledging that the global economic climate is playing a role in Hungary's improved market conditions, Finance Ministry State Secretary Almos Kovacs told Treasury that he believes the market is reacting positively to the government's fiscal consolidation and structural reform efforts (reftel). Budapest Bank (a GE Capital company) Fund Manager Peter Doronelly agrees, and notes that it is a strong statement to markets that at a time when Hungary is facing its deepest recession since the change of system, the government can maintain one of the lowest budget deficits in the EU.

¶6. (C) Although many believe FIDESZ has benefitted from the Bajnai government undertaking most of the difficult economic reforms, opposition-oriented economists point out that

despite the reforms, Hungary's tax wedge remains high, and that deeper structural reforms are needed to increase Hungary's economic competitiveness. They note that Bajnai has done little to simplify government administration, reduce the size of the informal economy, or combat corruption. Doronelly and others are more positive, however, noting that the Bajnai government "enacted those structural reforms they had room for," given both their limited mandate and short time in power.

GOVERNMENT BUDGET

¶7. (C) Finance Ministry State Secretary Kovacs told us the government believes it will meet its 2009 budget deficit target of 3.9 percent, noting that although nearly 85 percent of the deficit target has already been reached, seasonality issues and the elimination of thirteenth month pension payments should enable the government to meet its target. The government plans to base the 2010 budget on its previously announced deficit target of 3.8 percent. Kovacs noted that the draft 2010 budget will be submitted to Parliament on September 10, with the intention of passing the budget by November, more than a month earlier than has typically been the case. Although the details of the 2010 budget have not yet been released, the government has announced plans to cut funding for public transportation, as well as funding to local governments. In order to offset the reduction in local government funding, Kovacs noted that the government intends to eliminate certain tasks required of local authorities, but noted that no decision has been made as to which tasks will be eliminated.

WWVD: WHAT WILL VIKTOR DO?

¶8. (C) Focus is increasingly shifting towards the national elections next April and the expected victory of the opposition FIDESZ party. Analysts and commentators reporting on FIDESZ thinking on economic issues, however, often emerge with few specifics. FIDESZ economic experts like former Finance Minister and National Bank Governor Zsigmond Jarai and others tell us privately that they are aware of little work being done on the details of a FIDESZ economic program,

most likely out of concern that if details became public, it could adversely impact voter support. Accordingly, media reporting focuses on the sweeping and sometimes contradictory statements of FIDESZ President Viktor Orban. FIDESZ supporters generally discount these statements as campaign rhetoric, and tend to rely on faith that once in power, FIDESZ will undertake macroeconomic policies that will help restore Hungarian growth and improve competitiveness. They often point to the economic record of the 1998-2002 Orban government, which is generally viewed as more fiscally responsible (running smaller budget deficits and achieving a lower debt-to-GDP ratio) than the subsequent Socialist governments of Peter Medgyessy and Ferenc Gyurcsany.

¶9. (C) Mr. Jarai tells us that, "Orban understands economic issues and what needs to be done" but notes that given broader political considerations Orban must take into account, "we still don't know what he is going to do" on economic policy. Most believe that once in power, FIDESZ will make symbolic gestures like abolishing the new property tax, but that they will continue most of the reforms launched by the Bajnai government. FIDESZ economic experts like former Finance Minister Mihaly Varga speak only in broad terms about the need to streamline government, eliminate corruption, and reduce the size of the informal economy. Some FIDESZ economists, including Mr. Jarai, advocate for the introduction of a flat tax, which they believe will help simplify the tax system and improve Hungarian economic competitiveness. Jarai tells us that Orban agrees that a flat tax can have economic benefits, but has concerns that it would give the appearance of favoring the wealthy.

COMMENT: SPEAK NO EVIL

¶10. (C) After losing national elections in 2002 and 2006, Orban appears determined to prevent any erosion of support for his party prior to the elections. Having experienced a slight downturn in support last year once it became public that FIDESZ would consider changing 13th month pension rules, it now appears that there will be little development or articulation of specifics of an economic program prior to the elections. Although this strategy may help ensure Orban becomes prime minister, it also poses several risks. First, by not preparing the population for further austerity measures, the government will lack a specific mandate for

tough reforms, and may find itself faced with a surprised and resistant electorate. Second, by not developing the specifics of its economic plan until after the elections, further reforms will be delayed by several months, possibly creating uncertainty for markets and giving the impression that the government lacks an economic vision for Hungary. In the meantime, a substantial majority of Hungarians continue to believe that whatever economic plan Orban adopts, it will be better for Hungary than that of the current government. We have heard little, however, to suggest that the FIDESZ plan will be much different.
LEVINE